No. 14880

United States Court of Appeals

FOR THE NINTH CIRCUIT

In the Matter of
THE BRIDGFORD COMPANY, a Corporation, Bankrupt.

PAUL W. SAMPSELL, Trustee in Bankruptcy for the Estate of The Bridgford Company, a Corporation, Bankrupt,

Appellant,

vs

HUGH H. BRIDGFORD,

Appellee.

APPELLEE'S BRIEF

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STATEMENT OF THE CASE

To facilitate a better understanding of the issue here involved it is necessary to supplement and correct the Statement of Facts contained in Appellant's Brief. The material facts in chronological order are as follows:

1. On April 25, 1947, the petition under Chapter XI of the Bankruptcy Act was filed herein by The Bridgford Company. (Transcript of Record p. 3 (hereinafter referred to as R.))

2. On said date of April 25, 1947, and prior thereto Appellee was the president, a director and principal shareholder of The Bridgford Company. (R. p. 177) However at no time after the filing of said petition did Appellee as such president, director or principal shareholder have any connection with or control of the business affairs of The Bridgford Company.

3. On April 25, 1947, the Court assumed control of the assets of The Bridgford Company, appointed M. E. Wagenheim as General Manager of the Company and, through said General Manager, thereafter controlled and conducted the business and affairs of said Company continuously until November 6, 1947. (R. p. 16)

4. On November 6, 1947, the Court appointed R. H. Hadley as General Manager of the Company and, through said General Manager, thereafter controlled and conducted the business and affairs of said Company continuously until February 26, 1948. (R. p. 16)

5. On February 26, 1948, the Court by its

order approved the Plan of Arrangement for the Company and directed that the Company "shall take over its business and assets and operate such business without Court control". (R. p. 26) At that time Mr. Hadley was the Chairman of the Board of Directors and principal shareholder of the Company and he operated and controlled the Company free of court control continuously from February 26, 1948 until November 24, 1948. (R. p. 197)

6. On November 28, 1947, and on January 23, 1948, the Court by its orders authorized the issuance by The Bridgford Company of not to exceed 46 Certificates of Indebtedness for $5,000 each. (R. pp. 19 and 23) All of these Certificates were issued to Mr. Hadley for cash in the face amount thereof loaned by him to the Company. (R. pp. 169-170) At the time both of said orders were made, Mr. Hadley was General Manager of the Company by appointment of Court and was operating the Company's affairs under the Court's control. (R. p. 187) These Certificates, pursuant to the terms thereof, were given priority. (R. p. 22) All of these Certificates were subsequently repaid by the Company except Certificates Numbers 35 to 40, both inclusive, which are the basis of Appellee's claim and are the subject matter of this appeal. At this time there is unpaid the face amount of said Certificates aggregating $30,000 plus interest against which Appellant has an offset against Appellee of $10,996.40.
(R. p. 141)

7. During the period that Mr. Hadley was running the Company free of Court control, to-wit from February 26, 1948, to November 24, 1948, the Company incurred all of the debts (including the debts to the Oregon farmers for produce) which Appellant

asserts should be prior to Appellee's claim on said Certificates of Indebtedness. (R. p. 197)

8. On November 24, 1948, on petition of the Company the Court resumed control of the Company, its business and assets, and appointed Appellee General Manager, later adding two Co-General Managers. (R. 177-178) The Court retained control of the Company through said General Managers continuously thereafter, until the adjudication in bankruptcy was made on November 8, 1949. (R. p. 65)

9. On November 4, 1949, said Certificates Numbers 35 to 40, both inclusive, were transferred and assigned by Mr. Hadley to Mr. Bridgford as a gift. (R. pp. 140 and 166)

10. On February 13, 1953, Appellee filed herein his claim on said Certificates Numbers 35 to 40 in the amount of their face amount, i.e., $30,000 plus interest. (R. p. 96)

11. On November 13, 1953, the Referree allowed said claim of Appellee but subordinated it to the payment of all other claims. (R. p. 118)

12. By orders of Judge Ben Harrison on August 20, 1954, and on May 23, 1955, (R. pp. 138 and 148) said order of the Referree was modified and Appellee's claim was held to be prior over general creditor's and subordinate to expenses of administration and court costs.

THE ISSUE

There is only one issue involved here.

Appellee maintains that said orders of Judge Harrison are correct and that Appellee is entitled to priority on his claim on said Certificates over general creditors, subordinate, however, to expenses of administration and court costs. Appellant contends that Judge Harrison's orders are in error and that Appellee's claim should be subordinate to all other creditors.

IRRELEVANT AND IMMATERIAL MATTERS RAISED BY APPELLANT

Redundantly throughout Appellant's Brief are matters which to Appellee appear irrelevant and immaterial such as the following:

1. The fact that Appellee at one time was the president, a director and principal shareholder of The Bridgford Company, has no bearing on the issue in this case. All of the facts involved herein arose long after he had either lost these positions or they had become stripped of all authority.

2. The fact that Appellee, then one of the Co-Managers of the Debtor in possession, did on November 7, 1949, pursuant to order of the Referee herein, pay a number of expenses of administration including the payment to himself on said Certificates of Indebtedness is immaterial. (R. p. 63) He was later ordered to repay these moneys and he is in compliance with said order as thereafter amended. (R. p. 143) As Judge Harrison states,

> "Any possible misuse of his position by virtue of the fact that he obtained payment for these Certificates with knowledge that the

> "Debtor was about to be adjudicated a bankrupt, was erased by order of the Referee requiring him to pay back the money so obtained". (R. p. 137)

The Referee did not feel that the payment of November 7, 1949, precluded Mr. Bridgford from asserting a claim of priority at the proper time. The Referee in his Order of January 16, 1953, stated in part,

> "It is further ordered that the Findings of Fact and Conclusions of Law and Order heretofore made herein, dated November 17, 1952, are and were made without prejudice to the right of the said Hugh H. Bridgford to claim and assert a priority status and a preference for said claims on said Certificates of Indebtedness* * * *". (R. p. 95)

Therefore, the fact of the payment on November 7, 1949, is moot and closed.

3. The fact that some of the assets of this bankrupt estate may have come from the sale of produce supplied by Oregon farmers for which payment has not been made is immaterial. Appellee states that there is about $100,000 due and unpaid from the Company to these farmers. There is also upwards of $400,000 due to the other creditors including a claim by Mr. Hadley of approximately $119,612.88. There is nothing in the bankruptcy laws that gives farmers as such, any preference over any other general creditors. Furthermore it is incorrect to state, as Appellant does, that Appellee is seeking payment for himself out of funds realized from the sale of the

produce supplied to him by these farmers. In the first place, a substantial part of the assets herein comes from the liquidation of equipment, machinery, etc. (R. pp. 266-267) and, in the second place, all of this produce was sold to the Company by these farmers during the 1948 growing season when Hadley was running the Company and Appellee was entirely out of the picture. (R. p. 197) We are all sympathetic to unpaid creditors whether or not they are farmers. But where, as here, we have approximately $500,000 in general claims, whether Appellee's claim is or is not given priority is not going to have much practical consequence to any creditor except Hadley. Also it should be noted that all of these creditors extended credit in 1948 after Appellee's Certificates were issued and their priority made a matter of public record by order of court. Under these circumstances what basis do they have to blame anyone but themselves if these Certificates are now paid ahead of their claims?

ARGUMENT POINTS AND AUTHORITIES

Appellant, in his Brief, does not dispute the priority status of these Certificates of Indebtedness over general creditors but argues that because of Appellee's fiduciary position, these Certificates in his hands should be subordinated. Appellant on page 27 of his Brief admits that

> "It may be true that had Hadley retained these Certificates he would have been entitled to payment in full".

We therefore deem it proper to proceed in this Brief on the basis that Appellee's claim is admittedly entitled to priority over all general unsecured creditors unless

equity will deny this priority because of Appellee's fiduciary position.

We will now examine this fiduciary position in the light of the facts involved to see what, if any, effect it should have on the issue of priority.

Appellee was a court appointed Co-Manager from November 24, 1948 until November 8, 1949. Admittedly he was, in such capacity, a fiduciary and owed a duty not to secure an advantage by reason thereof. It is submitted that Appellee did not.

These Certificates were issued in February 1948, under court order long before Appellee was appointed. He had nothing to do with their issuance. They were issued for full consideration to Hadley who, himself was then the court's appointed Manager. They were retained by Hadley until November 4, 1949, on which date he made a gift of them to Appellee. On that date Appellee was the court's appointed Manager and Hadley was Chairman of the Board, a Director and the principal shareholder of the Company. Hadley is not complaining. As a matter of fact, Hadley in his testimony of February 1, 1952, several times reaffirmed the gift. (R. pp. 166-167) What right do the general creditors have to complain over this gift? How were they hurt? Why should this gift cause these Certificates to become subordinated thus resulting in a gift or windfall to the general creditors. Appellee merely stepped into Hadley's shoes. As Judge Harrison states,

> "Petitioner (Appellee) has succeeded to the position of his assignor (Hadley) and the fact that he himself gave no consideration for these Certificates is not material. Petitioner

"(Appellee) himself did nothing to detract from the position given to him by his assignor. His duty as a court appointed officer is not violated when he seeks to realize on rights to which he is entitled by valid order of that court." (R. p. 137)

Judge Harrison's conclusion of law covers this point as follows:

"That Petitioner (Appellee) although occupying the position of a fiduciary as to the Bankrupt when he acquired these Certificates, did nothing to detract from the position given to him by H. H. Hadley, his assignor, also a fiduciary as to the Bankrupt and, therefore, Petitioner's (Appellee's) fiduciary position, as aforesaid, does not in any way detract from the rights he might have otherwise had with reference to said Certificates if he had not occupied said fiduciary position." (R. p. 141)

As further stated by Judge Harrison:

"Under these circumstances the position to be afforded his (Appellee's) claim was to be determined solely by the position which the court gave to the Certificates at the time they were issued. The position so given these Certificates, was to be one of priority over existing claims and the integrity of the Certificates and thus this position is to be maintained." (R. p. 137)

Since both parties seem to agree as to the

law and disagree as to its application we want to discuss some of Appellant's citations.

Two important factual differences exist in most of Appellant's cases which make these decisions inapplicable here. In these cited cases there was

1. A trafficking in or purchasing of the debtor's obligations whereas here we have a gift or

2. A dealing in the debtor's assets whereas here we have a debt.

In the case of Bonney vs. Tilley, 109 Cal. 346, cited by Appellant it is stated:

> "It is to be observed, however, that a person who is a creditor of an insolvent corporation is not deprived of any of his rights as creditor by the fact that he also occupies the position of director of the company. He is merely incapacitated as director from using any of the powers of his position for his own benefit or his co-directors."

So it is clear that a fiduciary may acquire and have a valid claim. It is only where he, in some way, uses his power as a fiduciary, either in acquiring or enforcing the payment of the claim, that his fiduciary position in any way affects the validity, the amount or the priority of his claim. He is precluded only from using the powers of his position to gain an advantage. Wherein, in this proceeding, has Appellant made any showing that Appellee used the powers of his position to gain an advantage?

The Van Sweringen Company case, 119 Fed. 2d 231, cited by the Appellant is clearly distinguishable on its facts. In that case, we had fiduciaries trafficking in the securities of the corporation to whom they owed a fiduciary duty and purchasing such securities at less than their real value. This was obviously against and detrimental to the interests of the corporation to whom they owed a fiduciary duty and they were using the knowledge acquired by them in their fiduciary capacity of the real worth of the corporation to purchase securities of the corporation at less than their real value from persons who had no way of knowing their real value.

The case of Meinhard vs. Salmon, 249 N. Y. 458, also cited by Appellant, involves a situation where one partner, representing himself to be the sole owner of a partnership asset, did thereby secretly acquire a personal profit to himself to the exclusion of his partners. Obviously, he thereby violated his fiduciary duty to his partners. Obviously, also, this case is not pertinent to the issues now before this reviewing Court.

The Appellant cites the case of Los Angeles Lumber Products Co., 46 Fed. Supp. 77. It should be noted that this case was cited but not followed in the case of Re Calton Crescent, 173 Fed. 2d 944, discussed later, where the Court reached an entirely different conclusion. The Los Angeles Lumber Products case, in any event, is not in point because it has many distinguishable facts, such as

1. In the Los Angeles Lumber Products case, we have a fiduciary trafficking in the debtor's obligations, which is not involved in our case.

2. In the Los Angeles Lumber Products case,

we have a fiduciary purchasing the debtor's obligations from creditors who were not fiduiaries. In our case, the obligation was given from one fiduciary to another fiduciary.

3. In the Los Angeles Lumber Products case, we have a fiduciary purchasing obligations of the debtor incurred by the debtor in the ordinary course of business. In our case, the obligations involved were incurred pursuant to prior authorization of this Court, not in the ordinary course of business, and expressly made prior in status by order of this Court.

4. In the Los Angeles Lumber Products case, the fiduciary in question was not only a director but also attorney for the debtor and the Court suggests that his activities in acquiring his client's obligations might, even though it did not, preclude him from being entirely without self-interest in handling the legal affairs of the debtor.

Appellant also cites the case of Canton Roll & Machine Co. vs. Rolling Mill Co., 168 Fed. 465, where the fiduciary questioned was an officer of two corporations and he used his position as such officer in one to enable that corporation to gain an unfair advantage over the second corporation, which resulted in a sale of the second corporation's collateral, which he purchased secretly for his own use. This case is clearly not in point.

The only other case on this issue cited by Appellant is the case of Martin vs. Chambers, 214 Fed. 769, wherein the purchase of a corporation's obliga-

tions by an officer was approved and his claim sustained. If the facts were similar to our case, we would cite this case in support of our contention.

The contention of Appellant that this Court has the power to subordinate the claim of Appellee in the event that this Court, in its discretion, determines that the equities of this claim under all the facts and circumstances of this case, so require, is admitted. The existence of this power is elementary.

We would now like to cite and discuss the more recent cases concerning the position of a fiduciary and the status of claims acquired and presented by a fiduciary. The leading recent authority on the subject is the case of Re Calton Crescent, 173 Fed. 2d 944. The facts in that case are briefly as follows:

> Claimants purchased, at less than ten cents on the dollar face value, certain indenture bonds of the debtor during the period that the debtor was insolvent. These purchases were made after a plan of reorganization of the debtor had been effected and before the arrangement proceedings under the Bankruptcy Act had been started. These purchases were from sellers who were not fiduciaries and, in some instances, were made direct and some were made from dealers in over the counter securities. The claims on these debentures in said arrangement proceeding are the subject matter of this case. The claimants were found to be in the same fiduciary capacity as a director of the debtor. The claimants claimed the face amount of the indentures so purchased and the Trustee

objected that the claims should be allowed not in their face amount but in the amount of the purchase price actually paid by claimants.

The court held:

First, that the Federal law, not the State law, determines the extent to which inequitable conduct of the claimant requires subordination of the claim.

Second, that claimant will not be deprived of the profits of his transactions in the debtor's securities on the grounds of their acquisition by use of information acquired as a Fiduciary without adequate disclosure to the Sellers where no complaint of over-reaching is made by the Sellers who had as full information concerning the debtor's financial condition as the claimant.

Third, a director of an insolvent corporation is not precluded from purchasing claims against the corporation at a discount and then collecting the full amount of the claims, at least in the absence of over-reaching of the sellers or other circumstances requiring the imposition of sanctions.

The Court allowed the claims at their face value and without regard to the actual cost thereof to claimants. This decision was affirmed by the Supreme Court of the United States on No. 21, 1949, 338 U. S. 304.

We would like to quote the following excerpts from this case:

"As to the first question the appellant is right--federal law controls the distribution to creditors in bankruptcy. The Supreme Court has declared the rule very definitely. In Prudence Realization Corporation v. Geist, 316 US 89, at page 95, 62 S Ct 978, at page 982, 86 L Ed 1293, the court said; '...The court of bankruptcy is a court of equity to which the judicial administration of the bankrupt's estate is committed, Securities and Exchange Commission v. United States Realty & Improvement Co. 310 US 434, 455, 457, 60 S Ct. 1044, 1053, 1054, 84 L Ed 1293, and it is for that court--not without appropriate regard for rights acquired under rules of state law--to define and apply federal law in determining the extent to which the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy requires its subordination to other claims which, in other respects, are of the same class.'

"Later cases have reiterated the rule. American Surety Co. vs. Sampsell, 327 US 269, 272, 66 S Ct 571, 90 L Ed 663; Heiser v. Woodruff, 327 US 726, 732, 66 S Ct 853, 90 L Ed 970; Vanston Bondholders Protective Committee v. Green, 329 US 156, 161-163, 67 S Ct. 237, 91 L Ed 162. For earlier cases on the general subject, see Pepper v. Litton, 308 US 295, 303-304, 60 S Ct 238, 84 L Ed 281; American United Mut. Life Ins. Co. v. City of Avon Park, 311 US 138, 146, 61 S Ct. 157, 85 L Ed 91, 136 ALR 860. From these decisions we understand the rule to be that, although the state law determines the title, validity and

"amount of a claim, the bankruptcy law, including what federal judges think to be equitable, determines what dividends shall be distributable to the claimant. In other words, in addition to those modifications which the Bankruptcy Act itself has imposed upon distribution with respect to preferences, priorities and the like, the courts must impose any other modifications which they deem necessary in the interest of justice."

. . . . . .

"It is, of course, axiomatic that a fiduciary will not be permitted to profit at the expense of his cestui from any transaction where his fiduciary duty and his personal interest may come into conflict. This principle, however, does not preclude a director from purchasing a claim at a discount and collecting its face amount, if his company is solvent, since who holds the debt can be of no concern to a solvent company. It is not immediately apparent why insolvency should make a difference. It will cost the debtor no more whether the dividend which it may be able to pay creditors goes to the original holder of the debt or to a director-assignee. Counsel for the Securities and Exchange Commission suggests that insolvency creates a possible conflict between duty and personal interest because the directors can choose the time for filing a bankruptcy petition and may accelerate or postpone it if doing so can result in a personal profit. The argument as to the timing of bankruptcy has no force after the petition has been filed, yet the law is better settled with respect to

"purchases made after the petition is filed than those made before. After insolvency it may be said that the directors are fiduciaries for the group of creditors who will share in the insolvent's estate. But the creditors who have retained their claims will suffer nothing whether or not the director is allowed to make a profit from his purchases. If a wrong has been done to any of the group of cestuis, it is to those who sold their claims at a price less than the dividend they would have received had they retained them. If they were suing for the wrong done them, they would have to show something equivalent to a fraudulent non-disclosure. Strong v. Repide, 213 US 419, 29 S Ct 521, 53 L ed 853. Plainly if the contest for the director's profits was between the wronged cestuis and the unwronged cestuis, the former should prevail. Where it is between the unwronged cestuis and a director, if the former are allowed to prevail it can only be as a disciplinary measure against the director for wronging someone who has not complained of the wrong. That this is the real basis for the rule was recognized by Judge Kirkpatrick in the case of In re Real Estate Mortgage Guaranty Co. DCED Pa, 55 F Supp 749, 752, where he said: '... The doctrine that a receiver may not retain a personal profit made out of his trust is a prophylactic rule. It implements the law's precept that a trustee must give undivided loyalty to his trust. The surcharge is the sanction.... In the present case a substantial majority of the ultimate and only beneficiaries of the trust, knew of and consented to the receivers earning these commissions

"by placing the insurance through his own agency. I think that is a controlling factor and that it gives the court full discretion to deny the surcharge.'

"The same judge made a similar statement in Re Philadelphia & Western Ry. Co., DC, 64 F Supp 738, 741: 'This limitation is not imposed upon the theory that such profits belong to the corporation by reason of any property right that it may have in them but is an administrative sanction for the enforcement of the rules of fiduciary conduct set by the law.' If the doctrine be recognized as a disciplinary sanction within the discretion of the court to impose or withhold, then, as Judge Kirkpatrick also said in the Mortgage Guaranty Co. case, 'Each case depends on its own circumstances'. In the case at bar, where there was no overreaching of the sellers, we are not convinced that the circumstances are such as to require imposition of the sanction, even if the proof of debt had been filed by a director of the debtor."

It is interesting to note that Judge L. Hand agreed with the majority on the proposition that the federal law controls on the question of the extent to which inequitable conduct of claimant requires the subordination of the claim and not the State law. It is also interesting to note that while Judge Hand felt that the claimants should be allowed claims in the amount of the purchase price paid by them since they purchased from non-fiduciaries, that if the claims had been purchased by a director from a director, he would have agreed with the majority and allowed the

claims at the face amount thereof rather than at the purchase price paid by claimants. Referring to a purchase by a director from a director, he said:

"Surely they stand on an equality".

We submit that the standing of Appellee in this case is far superior by reason of several distinguishing facts to the position of the claimants in the Re Calton Crescent case. Appellee's claim was acquired from an equal fiduciary. Appellee did not purchase or traffic in the open market. Appellee acquired by gift. The claims in the Re Calton Crescent Case were based on obligations incurred by the debtor in the normal course of its business while Appellee's claim is based on an obligation authorized and expressly made prior in status by order of this court.

We do not deem it necessary to expand this brief with further citations on this issue since the subject has been very completely covered, replete with citations, in an excellent recent article in American Law Reports, 13 ALR 2d, page 1172.

CONCLUSIONS

The priority status of this claim on the Certificates of Indebtedness is admitted--in the absence of inequities.

So we come to the only question in this case. Are there any equities which require the subordination of these Certificates? We submit that there are none because:

1. These Certificates were originally issued

for a full cash consideration and given a prior status at time of issuance by Order of the Referee herein.

2. These Certificates were orginally issued to Mr. Hadley, a Fiduciary, and by him, while still a Fiduciary, given to Appellee.

3. Mr. Hadley has re-affirmed the gift and makes no complaint to this claim as a claim entitled to priority.

4. There was no trafficking in these Certificates. They were acquired by gift.

5. Appellee neither sought nor gained any advantage by reason of his Fiduciary capacity.

6. No one to whom Appellee owed a Fiduciary duty was harmed or in any was affected by his acquisition of these Certificates. The position of all parties involved remains unchanged except that Appellee has stepped into Mr. Hadley's shoes as the owner of these Certificates.

We respectfully submit that the claim of Appellee is just and equitable and that the Orders of the District Court should be affirmed.

Respectfully submitted,

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